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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC); REVIEW OF SWEDISH ECONOMY

REF: EDR(78)6, ADDENDUM AND ANNEXES

1. SUMMARY: SECRETARIAT DRAFT SURVEY PRESENTS 1977
SWEDISH ECONOMIC OUTCOME AGAINST BACKGROUND OF OVER-
RIDING GOVERNMENT POLICY OBJECTIVE OF MAINTAINING HIGH
EMPLOYMENT. DOMESTIC DEMAND AND OUTPUT, FOR 1977 AND
FORECAST FOR 1978, ARE STAGNANT OR FALLING -- YET
UNEMPLOYMENT RATE NEAR HISTORICAL LOWS. PRICE AND
EXTERNAL DEFICIT PRESSURES NOW CAUSING POLICY SHIFTS
TO MORE SELECTIVE EMPLOYMENT SUPPORTING MEASURES IN
PLACE OF GENERALIZED MACRO DEMAND MANAGEMENT. SPECIAL
SECTIONS ON WAGE DIFFERENTIALS AND MEDIUM-TERM OUTLOOK
BOTH INDICATE CRITICAL IMPORTANCE OF WORLD TRADE
RECOVERY TO SWEDEN'S ABILITY TO MEET ITS OBJECTIVES
OF RESTORING INTERNAL AND EXTERNAL BALANCE BY 1985.
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MISSION OFFERS SOME PRELIMINARY COMMENTS ON SECRETARIAT'S
DRAFT IN PARA. 8, AND WELCOMES FURTHER SUGGESTIONS
FROM WASHINGTON AGENCIES AND EMBASSY STOCKHOLM. MIS-
SION LOOKS FORWARD TO PARTICIPATION OF EMBASSY E/C
OFFICER BUTCHER IN MARCH 15 EDRC REVIEW. END SUMMARY

2. RECENT TRENDS: AGAINST THE BACKGROUND OF POLICY

DESIGNED TO MAINTAIN EMPLOYMENT AT VIRTUALLY ANY COST, THE SECRETARIAT INDICATES THAT 1977 ECONOMIC PERFORMANCE IN SWEDEN SUCCESSFULLY HELD DOWN THE OPEN UNEMPLOYMENT RATE, DESPITE A THREE PERCENT FALL IN TOTAL DOMESTIC DEMAND AND A 2 PERCENT FALL IN GROSS DOMESTIC PRODUCT. INDUSTRIAL PRODUCTION FELL FOR THE FOURTH CONSECUTIVE YEAR. ALL COMPONENTS OF PRIVATE DEMAND FELL WHILE THE PUBLIC SECTOR EXPENDITURES ROSE MORE THAN ANTICIPATED. INCREASED EMPLOYMENT IN THE PUBLIC SECTOR (UP 55,000) ALMOST COUNTERACTED DECLINE IN THE PRIVATE (DOWN 57,000), YIELDING A LOSS OF ONLY 2,000 JOBS. NEVERTHELESS, UNDERLYING MEASURES OF LABOR MARKET CONDITIONS (VACANCY/UNEMPLOYMENT RATE, VOLUNTARY JOB LEAVERS) INDICATE A MORE FUNDAMENTAL DETERIORATION IN EMPLOYMENT PROSPECTS. LABOR MARKET SLACK RESULTED IN WAGE MODERATION (3 PERCENT NEGOTIATED INCREASE, 3 PERCENT WAGE DRIFT) -- WHILE INCREASED TRANSFERS TO NON-WAGE EARNERS RESULTED IN A SLIGHT SHIFT OF REAL DISPOSABLE INCOMES SHARE IN FAVOR OF THE LATTER. WAGE RESTRAINT WAS NOT REFLECTED IN LABOR COST DEVELOPMENTS DUE TO HIGHER EMPLOYERS' SOCIAL SECURITY PAYMENTS AND UNFAVORABLE PRODUCTIVITY DEVELOPMENT, THUS PROFITS DECLINED 50 PERCENT, WITH SOME IMPROVEMENT AT YEAR END DUE TO THE DEVALUATION. INFLATION ACCELERATED TO 11-1/2 PERCENT YEAR-ON-YEAR, EXPLAINABLE IN TOTAL, IN A MECHANICAL SENSE, BY INDIRECT LIMITED OFFICIAL USE

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TAX INCREASES AND DEVALUATION EFFECTS (ALTHOUGH THESE ARE NOT YET FULLY DISPERSED THROUGH ECONOMY). IMPORT VOLUME FELL 4-1/2 PERCENT AS DOMESTIC DEMAND SLOWED, BUT EXPORTS WERE WEAKER THAN EXPECTED (SLIGHT VOLUME FALL VS. 6 PERCENT VOLUME INCREASE) DUE TO WEAKER GEOGRAPHICAL MARKETS, THE SWEDISH EXPORT GOODS MIX (HEAVILY WEIGHTED BY INVESTMENT GOODS DURING GLOBAL INVESTMENT SLUMP) AND SOME LINGERING EFFECTS OF 75/76 LOSS OF COMPETITIVENESS. TERMS OF TRADE DETERIORATION (DOWN 4 PERCENT) OVERCAME POSITIVE REAL BALANCE (1 PERCENT POSITIVE CONTRIBUTION TO GDP) CAUSING LARGE CURRENT ACCOUNT SURPLUS (14-3/4 BILLION KRONER, 4-1/2 PERCENT GDP). CAPITAL INFLOWS, VIRTUALLY ALL LONG-TERM ON NET BASIS AND HALF ACCOUNTED FOR BY GOVERNMENT, COVERED THE DEFICIT. IN 1977, SWEDEN'S FOREIGN POSITION CHANGED TO NET DEBTOR IN AMOUNT OF KR. 2 BILLION. MAJOR CHANGE IN EXCHANGE RATE POLICY (WITHDRAWAL FROM "SNAKE" IN AUGUST 1977)

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WAS ACCOMPANIED BY, BUT NOT NECESSARILY CAUSE OF, A
17 PERCENT EFFECTIVE DEPRECIATION FROM DECEMBER 1976.

3. ECONOMIC POLICY: DESPITE HIGH INFLATION, LARGE
CURRENT DEFICIT, LOSS OF COMPETITIVENESS, FISCAL POLICY
WAS HIGHLY EXPANSIONARY IN 1977 (MORE THAN ORIGINALLY
PLANNED) ALTHOUGH GREATER EMPHASIS WAS PLACED ON SELEC-
TIVE EMPLOYMENT AND INVESTMENT MEASURES AND ATTEMPTS
TO MAINTAIN INDUSTRIAL ACTIVITY. DIRECT TAX CUTS WERE
ALSO EMPLOYED TO COUNTERBALANCE THE SLIDE IN REAL EARN-
INGS. MONETARY POLICY WAS INTENDED TO BE TIGHT -- WITH
DIRECTED CREDIT TO BUSINESS ACTIVITY AND HOUSING.
MONETARY AGGREGATES ROSE MODERATELY (M2 AT 6 PERCENT
OR 1/2 NOMINAL GNP RISE), THANKS TO EXTENSIVE GOVERN-
MENT FINANCING ABROAD AND STERILIZING OF LIQUIDITY
EFFECTS THROUGH LONG-TERM BOND ISSUES.

4. OUTLOOK FOR 1978: SECRETARIAT FORECASTS FOR 1978
ARE BASED ON FISCAL POLICY AS EXPANSIONARY AS 1977 WITH
INTENDED TIGHT MONETARY CONDITIONS, ALTHOUGH LATTER
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THREATENED BY SHARP INCREASE IN MONETARY AGGREGATES
IN LATE 1977. PUBLIC SECTOR WILL PROVIDE 3 PERCENT

GDP STIMULUS, PRIMARILY FROM LOCAL GOVERNMENTS. PRIVATE DEMAND COMPONENTS ARE FORECAST TO DEVELOP AS FOLLOWS:

-- PRIVATE CONSUMPTION DOWN 2 PERCENT AS REAL HOUSEHOLD DISPOSABLE INCOME FALLS (DOWN 2-1/2 PERCENT) FOR THE FIRST TIME IN POST-WAR PERIOD BASED ON ASSUMPTION OF 8 PERCENT WAGE RISE (2 PERCENT NEGOTIATED, 2 PERCENT WAGEDRIFT, PLUS CARRYOVER) AND 8-9 PERCENT RISE IN NOMINAL HOUSEHOLD INCOMES. SAVING RATE SHOULD ON BALANCE FALL SLIGHTLY.

-- INVESTMENT IN HOUSING SHOULD STRENGTHEN ON BASIS OF LATE 1977 TRENDS, BUT BUSINESS FIXED INVESTMENT (INDUSTRIAL AND SERVICES) WILL FALL BY AS MUCH AS 15 PERCENT DESPITE SOME RECOVERY IN PROFITS AS UNIT LABOR COSTS MODERATE (UP 4 PERCENT). STOCKS SHOULD CONTINUE TO ADJUST DOWNWARD.

TOTAL DOMESTIC DEMAND SHOULD FALL 2 PERCENT, BUT THE FOREIGN SECTOR REAL BALANCE WILL PROVIDE A 2 PERCENT POSITIVE CONTRIBUTION (IMPORTS VOLUME DOWN 3 PERCENT, EXPORTS VOLUME UP BY 4-3/4 PERCENT CONSISTENT WITH GEOGRAPHIC MARKET GROWTH) -- THUS GDP REMAINS AT 1977 LEVEL. INDUSTRIAL PRODUCTION SHOULD FALL AGAIN (DOWN 1 PERCENTAGE POINT).

OPEN UNEMPLOYMENT WILL PROBABLY REMAIN STABLE AS PRIVATE SECTOR JOB LOSSES (50,000) AND LABOR FORCE INCREASE (UP 1/2 PERCENT) WILL BE COUNTERED BY PUBLIC SECTOR EMPLOYMENT.

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5. WAGE DIFFERENTIALS: IN A SPECIAL SECTION, SECRETARIAT ATTEMPTS TO ANALYZE DEVELOPMENTS IN WAGE DIFFERENTIALS AND THEIR IMPACT ON GENERAL ECONOMIC DEVELOPMENTS. STUDY SEEMS GENERALLY WEAK AND SOMEWHAT TOO IMPRESSIONISTIC, EMPLOYING EXTENSIVE CASUAL EMPIRICISM INTERSPERSED WITH SOME STATISTICAL ANALYSIS. MAJOR CONCLUSIONS ARE:

(A) NARROWING OF WAGE STRUCTURE (BY SECTOR) WHICH OCCURRED DURING 60'S SEEMS TO HAVE BEEN PARTIALLY REVERSED IN 73-76 PERIOD.

(B) DIVERGENCE OF PRODUCTIVITY AND WAGE TRENDS FOR PERIOD SINCE 1967 SEEM TO BE EXPLAINED BY "EFO" MODEL OF INFLATION, WHEREBY WAGE TRENDS ARE SET IN EXPOSED (HIGH PRODUCTIVITY) SECTORS ON BASIS OF PRICE AND PRO-

DUCITIVITY DEVELOPMENTS AND TRANSMITTED TO DOMESTIC SECTORS. THESE LATTER HAVE RESTRAINTS ON PRICES IMPOSED BY DOMESTIC DEMAND OR PRICE CONTROLS, THUS SUFFER FROM DECLINING PROFIT MARGINS. THIS DEVELOPMENT COULD LEAD TO ENHANCED INFLATIONARY PRESSURES WHEN DEMAND RECOVERS, UNLESS WAGE RESTRAINT HOLDS INCREASES IN LOW-PRODUCTIVITY SECTOR BELOW GENERAL TRENDS, WHICH WOULD MEAN WIDENING OF WAGE DIFFERENTIALS.

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6. OUTLOOK FOR MEDIUM-TERM: DRAWING ON ITS ANALYSIS OF WAGE STRUCTURES AS WELL AS ASSUMPTIONS ABOUT:

-- THE EXTERNAL ENVIRONMENT

-- SIZE OF THE PUBLIC SECTOR

-- DEVELOPMENT IN LABOR PRODUCTIVITY, AND LIKELY CAPITAL/LABOR RATIOS

-- DEPRECIATION DUE TO PRESENT RECESSION; I.E., NEED FOR CAPITAL "SCRAPPING,"

THE SECRETARIAT DEVELOPS SEVERAL SCENARIOS TO 1985 FOR SWEDEN GIVEN THE POLICY OBJECTIVES OF (A) MAINTAINING (RESTORING) FULL EMPLOYMENT AND NORMAL CAPACITY UTILIZATION RATES AND (B) RESTORING BALANCE IN THE CURRENT ACCOUNT. WITHOUT DETAILING HERE THE VARIOUS ALTERNATIVE SCENARIOS, THE SECRETARIAT CONCLUDES THAT SWEDEN'S LIMITED OFFICIAL USE

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TASK WILL BE EXTREMELY DIFFICULT UNLESS THERE IS A MAJOR RECOVERY IN GLOBAL MARKETS. IF SLOW GROWTH CONTINUES TO CHARACTERIZE SWEDEN'S TRADING PARTNERS, THEN SWEDEN WILL CONFRONT POLICY CONFLICTS AS DURING THE PAST THREE YEARS. SPECIFICALLY, HOW TO RETURN TO HIGHER UTILIZATION RATES (CAPITAL AND LABOR) WHILE MODERATING COSTS SUFFICIENTLY TO GAIN MARKET SHARES IN A SLUGGISH GLOBAL MARKET. EFFECTING INEVITABLE STRUCTURAL CHANGES MAY ALSO BE INCOMPATIBLE WITH HIGH EMPLOYMENT WITHOUT FASTER GROWTH ABROAD. BASICALLY, THE MESSAGE SEEMS TO BE THAT "SWIMMING AGAINST THE TIDE IS IMPOSSIBLE" UNLESS LARGE CURRENT ACCOUNT DEFICITS (AND CONCOMITANT FINANCING) ARE ACCEPTED.

7. CONCLUSIONS: ON THE BASIS OF ITS ANALYSIS, THE SECRETARIAT CONCLUDES:

(A) 1978 FISCAL POLICY IS TOO EXPANSIONARY, AND RELIES TOO HEAVILY ON MACRO MEASURES (TAX CUT) WHEN MORE SPECIFIC MEASURES (RETRAINING PROGRAM, AIDS TO CONSTRUCTION) WOULD HAVE GREATER INFLUENCE ON SECTORS NEEDING ATTENTION. DEMAND MANAGEMENT POLICY MUST BE CONSISTENT WITH THE NEED TO REDUCE INFLATION. MONETARY INSTRUMENTS MUST BE USED TO THE FULLEST TO COUNTERACT LIQUIDITY CREATING EFFECTS OF FISCAL POLICY.

(B) SWEDEN'S LABOR MARKET MEASURES ARE CONTRIBUTING TO THE EXPANSIONARY FISCAL POLICY AND MAY BE DELAYING ESSENTIAL INDUSTRIAL ADJUSTMENT. MORE ATTENTION SHOULD BE PAID TO MEDIUM-TERM IMPLICATIONS OF SHORT-TERM EMPLOYMENT SUPPORTING MEASURES.

(C) UNLESS RATE OF GROWTH OF WORLD TRADE ACCELERATES, LIMITED OFFICIAL USE

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SWEDISH GOALS OF FULL EMPLOYMENT AND EXTERNAL BALANCE WILL BE EXTREMELY DIFFICULT TO ACHIEVE. THIS IS PARTICULARLY SO DUE TO STRONG INTERNAL RESTRICTIONS ON

CONSUMPTION WHICH WILL BE NECESSARY TO CHANNEL FUNDS
TO CAPITAL FORMATION.

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8. MISSION COMMENTS:

(A) SWEDISH EXPERIENCE IS VIRTUALLY OPPOSITE OF DANISH
IN TERMS OF EMPLOYMENT SUPPORTING VS. UNEMPLOYMENT COM-
PENSATION POLICIES. RECENT REPORTING BY EMBASSY STOCK-
HOLM SEEMS TO INDICATE THAT, DESPITE LABOR SUBSIDIES
AND EXTENSIVE LABOR HOARDING, INDUSTRIAL RESTRUCTURING
IS TAKING PLACE. MISSION PLANS TO EXPLORE WITH SWEDISH
DELEGATION HOW GOS IS ABLE TO ENCOURAGE ADJUSTMENT WHILE
SUPPORTING EMPLOYMENT IN TRADITIONAL INDUSTRIES, AS WELL
AS ANY ANALYSIS AS TO STRUCTURAL/CYCLICAL CAUSES OF SEC-
TORAL WEAKNESS WHICH SWEDES MAY HAVE PERFORMED.

(B) SECRETARIAT REPORT REFERS TO EMPLOYED LABOR AS
"ACTIVE" SECTOR AND OTHERS, PRESUMABLY INCLUDING RENTERS
AND ENTREPRENEURS, AS "INACTIVE." THIS CHARACTERIZATION
SEEMS INAPPROPRIATE FOR SECRETARIAT DOCUMENT, AS IT HAS
OVERTONES OF NORMATIVE JUDGEMENT REGARDING ROLE OF CAPI-
TAL OWNERS.

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(C) LOW NOMINAL WAGE AGREEMENTS AND WAGE DRIFT ARE SOMEWHAT SURPRISING GIVEN LOW RATE OF OPEN UNEMPLOYMENT. MISSION PLANS TO ASK SWEDISH DELEGATION IF SPECIAL FACTORS; E.G., POTENTIAL IMPOSED SETTLEMENT, "SOCIAL CONSENSUS" ARE CONTRIBUTING FACTORS, OR WHETHER LABOR SLACK IS PREDOMINANT DESPITE LOW OPEN UNEMPLOYMENT.

(D) SWEDEN HAS NOW APPARENTLY DECIDED TO USE A MORE FLEXIBLE APPROACH TO EXCHANGE RATE THAN ITS NORDIC NEIGHBORS. MISSION HOPES THAT EDRC COULD EXPLORE THIS QUESTION ALTHOUGH U.S. DEL PREFERS TO STAY LOW-KEY ON EXCHANGE RATE QUESTIONS.
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